



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DONALD L. KOHN
DIRECTOR
DIVISION OF MONETARY AFFAIRS

October 21, 1998

Mr. William L. McQuillan
President
Independent Bankers Association of America
One Thomas Circle, N.W.
Washington, DC 20005-5802

Dear Mr. McQuillan:

Chairman Greenspan asked me to respond to your letter of September 21 regarding interest on reserves. You requested information quantifying the benefits for banks, stratified by asset size, were the Federal Reserve to pay interest on required reserve balances. While we have not conducted the exact exercise you described in your letter, I believe related work and general comments can shed some light on the issue you raise.

Board staff have estimated that, in the absence of paying interest, the aggregate level of required reserve balances will fall to the neighborhood of \$4 billion, and that these balances will be held by roughly 1,000 depository institutions. We do not have on hand the stratification by total assets of these 1,000 institutions. Our analysis examined such a group of institutions ranked by *total deposits*. That work suggested that almost all of the institutions that would receive interest on required reserve balances would likely be distributed roughly evenly in the top three quintiles of total deposits (that is, the top three groups of fifths), but that the dollar payments would be heavily skewed to those depositories in the top quintile. These are the banks that, in effect, would still be paying the reserve requirement "tax" if interest were not paid. Smaller banks have avoided this tax in part by special provisions in regulations, but in part also by instituting retail sweep programs. The latter, with associated expenses, would no longer be necessary.

Finally, the proposed legislation also would have allowed the Federal Reserve to pay interest on excess reserves. While we have no intention of using this authority in the near term, it is important to note that if the Federal Reserve decided to pay interest on excess reserve balances, the smaller depositories would be the main beneficiary of those payments as they hold the overwhelming majority of those balances. In addition, smaller depositories would benefit by being able to compete more equitably for business balances if the Congress allowed banks to pay interest on demand deposits, which was also in the package of legislation.

I hope you find this information useful.

Sincerely,

A handwritten signature in cursive script, appearing to read "Donald L. Allen". The signature is written in dark ink and is positioned below the word "Sincerely,".